

PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

ENERGY DIVISION

RESOLUTION E-4008

October 5, 2006

R E S O L U T I O N

Resolution E-4008. San Diego Gas and Electric Company [SDG&E] requests approval of its proposed investment management agreement [Agreement] with SIT Investment Associates, Inc. [SIT], and confirm the amendment to the investment management agreement [Amendment] with State Street Global Advisors [State Street].

Requests granted.

By Advice Letter 1808-E Filed on July 5, 2006.

SUMMARY

SDG&E's request is approved.

This Resolution approves the Agreement between SDG&E Nuclear Facilities Decommissioning Master Trust Committee [Committee] and SIT.

The Resolution also affirms the Amendment to the investment management agreement with State Street and authorizes the Commission's Executive Director or his designee to sign the Agreement and the Amendment on behalf of the Commission.

BACKGROUND

Externally managed trust funds to accrue the decommissioning trust funds.

In order Instituting Investigation No. 86, the Commission conducted an extensive investigation , on its own motion, into the recovery of costs of decommissioning nuclear power plants owned by the California utilities. In Decision [D.]87-05-062 the Commission adopted externally managed trust funds as vehicles for accruing decommissioning funds. In that decision the Commission also established guidelines for trust agreements.

SDG&E's Qualified and Nonqualified Trusts.

In response to D.87-05-062, SDG&E established two trusts; one to hold contributions that qualify for an income tax deduction under Section 468A of Internal Revenue Code [Qualified Trust], and another to hold the remaining funds [Nonqualified Trust]. By Resolution E-3060 dated November 25, 1987, the Commission approved SDG&E's trust agreements. D.95-07-055 provides for investment management agreements to be approved through the Commission's advice letter process.

Section 3.01 of both trust agreements provides for the establishment of the Committee. Subject to Commission approval, the Committee is authorized to appoint one or more investment managers to direct investments of all or part of the trusts' assets.

As of June 30, 2006, the total market value of SDG&E's nuclear decommissioning trusts was \$646 million.

Guidelines for Trust Investments

The Commission has set forth its limitations on the nuclear utilities' trust fund investments in a series of decisions. In D.87-05-062 the Commission concluded that Nonqualified trust fund investments in high quality *equity* securities [i.e. company shares] shall not exceed 60% of the trust fund's fair market value. Therefore the *fixed-income* [i.e. bonds and commercial paper] allocation must be at least 40% of the Nonqualified Trust investments. Most recently, D.95-07-055 authorized that up to 50% of the fair market value of Qualified Trust funds may be invested in publicly traded equity securities. Of these, 40% may be invested in non-US company stocks.

SDG&E Trust Management

Presently the managers of the Trusts are as follows:

Nonqualified Trust

NISA: for fixed-income assets.

State Street: for equity assets.

Qualified Trust

NISA: fixed-income

TCW: fixed-income

Alliance Bernstein: fixed-income

State Street: US and foreign equities
UBS: foreign equities.

SDG&E requests approval of the investment management agreement with SIT to replace NISA as manager of fixed-income assets for the Nonqualified Trust. SDG&E contends that the replacement will facilitate investment within the levels authorized by the Commission in D.87-05-062 and D.95-07-055 and achieve appropriate diversification to maximize returns on a risk-adjusted basis.

The SIT Agreement is not materially different than other management agreements.

The proposed Agreement between the Committee and SIT is substantially the same as the Agreements previously approved by the Commission. The investment manager's annual fee schedule for SIT is in Appendix B to AL 1808-E. The fee schedule states the method of calculation of fees payable to SIT and frequency of payments. SIT management fee schedule complies with the guidelines ordered in D.87-05-062.

SDG&E's second request

The Committee in its June 19, 2006 meeting considered the proposal to change the benchmark of all the US equity accounts, for both Trusts, currently managed by State Street, from Russell 3000 to MSCI US 2500. Benchmark here is a standard or an index of a set of securities used for comparison purposes. The Committee's goal is to beat or at least to replicate the benchmark. In order to make the change in the benchmark, State Street requires an Amendment to its investment management agreement with SDG&E, which needs the Commission's approval. The Amendment could slightly change the composition of the portfolio due to the change in the index.

NOTICE

Notice of AL 1808-E was made by publication in the Commission's Daily Calendar. SDG&E states that a copy of the Advice Letter was mailed and distributed in accordance with Section III-G of General Order 96-A.

PROTESTS

Advice Letter 1808-E was not protested.

DISCUSSION

SDG&E proposes replacing the currently engaged NISA Investment Advisors [NISA] by SIT to manage the fixed-income assets of the *Nonqualified* Trust. NISA, however, will stay on as a fixed-income asset manager of the *Qualified* Trust. In February 2006, NISA was *temporarily* assigned to the management of *Nonqualified* Trust fixed-income accounts by Resolution E-3966 until a new manager was found.

The process of selecting SIT

Market value of *Nonqualified* Trust's fixed-income assets, as of June 30, 2006, was about \$33 million. To find a manager for these accounts, SDG&E states that its staff considered 18 investment management firms that included minority-owned and veteran firms. According to SDG&E, the search further concentrated on five investment managers: SIT, AllianceBernstein, Standish Mellon, PIMCO, and BlackRock. The criteria used for evaluation were:

- Consistent investment management process for taxable assets.
- Strong risk-adjusted investment returns, pre-tax and after-tax.
- Strong risk management and compliance systems and competitive investment management fees.

Following evaluation of the available information, the staff recommended SIT as the fixed-income manager for the *Nonqualified* Trust. At its June 19, 2006 meeting, the Committee concluded that based upon the staff's analysis and their own independent judgment, SIT can fulfill the Committee's goals and objectives for the fixed-income manager and approved the selection of SIT to replace NISA.

SIT overview

Attachment B to AL 1808-E states that SIT is an 85% employee-owned investment management firm founded in 1981. It is one of the largest minority-owned firms in the country with about \$6.8 billion assets under its management as of March 31, 2006, \$4.5 billion of which is in the form of fixed-income assets. It is a stable firm with no ownership changes and has never been involved in litigation. SIT has 73 employees, 30 of which are investment professionals.

Energy Division's view of SIT

The Energy Division has reviewed SDG&E's agreement with SIT and concludes that it is in compliance with the applicable Commission requirements and that

the addition of SIT to the fixed-income management should be beneficial to the ratepayers as well as shareholders of SDG&E.

Energy Division's review has also determined that SIT's investment management fee schedule for the Nonqualified Trust complies with the guidelines ordered in D.87-05-062.

The amendment to the State Street management agreement

The Committee, at its June 19, 2006 meeting, approved changing the domestic [U.S.] equity benchmark in the State Street portfolios from Russell 3000 to MSCI US 2500 for both Qualified and Nonqualified Trusts.

Advantages of MSCI US 2500 over Russell 3000

The Committee's decision was based on the following stated advantages of MSCI:

- MSCI index is reviewed 4 times a year, whereas Russell 3000 reviewed only once a year.
- Reduced index turnover [i.e. stocks in/out of the index] compared to Russell, which results in more tax efficiency.
- Companies that just go public are not automatically added to MSCI index, but only if they meet certain criteria.
- Illiquid stocks and micro-cap [smallest stocks] are not included in MSCI.
- Long term returns are higher compared to other major indices.

In short, the Committee sees higher returns and lower volatility in returns by switching to MSCI. Attachment C to AL 1808-E contains the proposed amendment, the management fee schedule, and detailed comparisons of the MSCI 2500 vs. Russell 3000 indexes. SDG&E staff has also managed to negotiate a lower management fee structure with State Street because of the increased asset size of the accounts in the past 10 years.

The Energy Division has reviewed the amendment to the agreement with State Street regarding the change in domestic equity benchmark and the new management fee schedule and concludes that the agreement is in compliance with the Commission requirements and the fee schedule complies with the guidelines of D.87-05-062.

Accordingly, the Energy Division recommends approval of the request by authorizing the Executive Director, or his designee, to sign the investment management agreement and the amendment letter on behalf of the Commission.

COMMENTS

This is an uncontested matter in which the resolution grants the relief requested. Accordingly, pursuant to PU Code 311(g) (2), the otherwise applicable 30-day period for public review and comment is being waived.

FINDINGS

1. SDG&E filed AL 1808-E on July 5, 2006 requesting approval of its investment management agreement [Agreement] with SIT Investment Associates, Inc. [SIT] and the amendment to the investment management agreement [Amendment] with State Street Global Advisors [State Street].

2. In D.87-05-062 the Commission required externally managed trust funds to finance the decommissioning of nuclear power plants.

D.95-07-055 requires that all investment management agreements be approved by the Commission through the advice letter process

3. In its June 19, 2006 meeting, SDG&E's Nuclear Facilities Decommissioning Master Trust Committee [Committee] approved the selection of SIT to replace NISA Investment Advisors as manager of fixed-income assets for the Non-qualified Trust. In that same meeting, the Committee confirmed changing the benchmark of all US equity accounts, currently managed by State Street, from Russell 3000 to MSCI US 2500.

4. The proposed Agreement between the Committee and SIT is substantially the same as the Agreement previously approved by the Commission, with the exception of the fee schedule.

5. The proposed amendment to State Street management agreement, changing the benchmark of US equity accounts to MSCI US 2500 indices, is substantially the same as the investment management agreements previously approved by the Commission, with the exception of the fee schedule.

6. The proposed agreement with SIT and the amendment to State Street agreement, including the fee schedules are in compliance with applicable Commission requirements and should be approved.

THEREFORE IT IS ORDERED THAT:

1. San Diego Gas & Electric Company's request in Advice Letter 1808-E is approved.
2. The Commission's Executive Director, or his designee, is authorized to sign the Agreement and the Amendment on behalf of the Commission.

This Resolution is effective today.

I certify that the foregoing resolution was duly introduced, passed and adopted at a conference of the Public Utilities Commission of the State of California held on October 5, 2006; the following Commissioners voting favorably thereon:

STEVE LARSON
Executive Director

MICHAEL R. PEEVEY
PRESIDENT
GEOFFREY F. BROWN
DIAN M. GRUENEICH
JOHN A. BOHN
RACHELLE B. CHONG
Commissioners